Non-standard and unconventional Monetary Policy Measures

Abstract
Big recessions or depressions, especially if they have been fuelled by a financial or credit bubble and burst, cannot be dealt with standard monetary policy tools. The ECB non-standard monetary policy measures - SMP, LTRO and, more recently, "unlimited" OMT and "forward guidance" on interest rates - have been instrumental to avoid a euro area break up, to fight against the perverse loop between banks and sovereigns and to establish more uniform lending conditions across euro area Member States. However, the narrow ECB mandate (price stability) and the absence of a macroeconomic target(s) for non-standard monetary policies weaken ECB commitments.
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**EXECUTIVE SUMMARY**

Big recessions or depressions, especially if they have been fuelled by a financial or credit bubble and burst, cannot be dealt with standard monetary policies consisting in raising or lowering short-term interest rates, even more so when policy rates are close to the lower bound (zero). Non-standard or unconventional monetary policies by central banks are needed in order to be able to face such extraordinary and serious events.

Key central banks, like the the US Federal Reserve (FED), the Bank of England (BoE), the Bank of Japan (BoJ) and the Bank of Canada (BoC) have undertaken unconventional monetary policies to avoid another Great Depression and have obtained reasonable good results. They did so before the ECB had been confronted with the financial crisis and the ensuing sovereign debt crisis. These unconventional measures represent other ways and means of fighting big recession once the lower bound for policy interest rate is reached or approached.

The ECB non-standard wrt unconventional monetary policies have specific features and several reasons explain the ECB initiative:

First, the ECB monetary policy is applied not to a country, as the FED in the US with its own Government and Treasury, but to 17 Member States of a Monetary Union with different Governments and Treasuries.

Second, the ECB’s monetary policy has not engaged in quantitative easing (QE) as most other central banks have done through non sterilised purchases in the markets of long-term public and private financial assets. All non-standard measures have been sterilised by the ECB.

Third, the ECB monetary transmission mechanism is broken for several euro area Member States in distress, therefore, standard monetary policy is ineffective.

Fourth, as the ECB’s main refinancing rate is approaching its “lower bound”, credit markets are still fragmented and with evidence of a renationalisation of the capital flows, the ECB is forced to engage in another non standard measure, so-called “forward guidance”.

All these ECB measures needed to be adopted in order to avoid a euro area break up, to fight against the perverse loop between banks and sovereigns and to restore the monetary transmission mechanism and more uniform lending conditions across euro area Member States.
INTRODUCTION

For several decades before the financial crisis, standard monetary policies of adjusting policy rates adopted by key central banks (FED, BoE, BoC, BoJ) succeeded in keeping inflation below an agreed benchmark and supporting growth. The same policy was undertaken by the ECB for the decade following its inception in 1998.

Nevertheless, the crisis has shown that interest rate expectations cannot be fully anchored by short-term policy rates, as many other factors both national and international play a role.

Moreover, for many years, the possibility that the main policy rate of central banks could ever reach a “lower bound” (close to zero) undermining the power of countercyclical monetary policy despite an undesirable low level of capacity utilisation and a low inflation or even a deflation was considered only “a theoretical curiosity” (Woodford, 2012).

The first central bank to face such a “theoretical curiosity” was the BOJ in the late 1990’s when a reduction to zero of its main operating overnight target - the “call rate” - was not sufficient to halt deflation in Japan. Despite the poor outcome, only in July 2006, did the BOJ stop making commitments to a zero interest rate policy. Japan has continued suffering from low growth and inflation until April 2013, when the BOJ president Kuroda finally decided to introduce unconventional monetary policy measures. Kuroda has promised to double Japan’s monetary base and the BOJ holdings of governemnt bonds and to achieve a target of 2 % inflation by 2015.

In the wake of the global financial and banking crisis of 2008 and with a deteriorating economic situation, the FED (and later the BoE and the BoC), started to use unconventional monetary policies (Gertler and Karadi, 2010). The US monetary policy rates has been - like in Japan - close to the lower bound (the Federal funds target band was between zero and 25 basis points since December 2008) without being able to stimulate growth. Inflation was lower than desired (Woodford, 2012).

Facing a similar economic and financial situation, the ECB has been using also “non standard measures” since July 2010, even if it had still room to lower short-term interest rates.

There are two major differences between the “non standard” measures taken by the ECB and the “unconventional” measures of the FED, BoJ, BoE and BoC.

First, the ECB activated non-standard measures even though its main refinancing rate (MRO) had not yet reached its lower bound as was the case in the US and Japan. It did so mainly because the euro area financial market fragmented along national borders and, as a result, the monetary transmission mechanism stopped working in some euro area Member States.

Second, the money injected by ECB through non-standard policy measures and largely used to buy government debt in distressed euro area Member States was sterilised. This, again, is in contrast to the FED, the BoJ or the BoE that let their monetary base to increase (i.e. quantitative easing). Three main reasons explain the different ECB approach:

First, the structure of financial intermediation. In the euro area, about 70 % of financial intermediation (credit) is operated by banks and only 30 % by financial markets, while exactly the opposite happens in the US. In the UK there is a 50 % split between bank-based and market-based financial markets.

Second, the risk profile of the collateral. While the FED and the BoE used to purchase “riskless” government bonds issued by the corresponding treasury, the ECB has been buying...
government bonds issued by 17 different euro area treasuries which were featuring very different credit-risks, according to market assessments.

Third, the role of monetary policy. The key mandate of ECB is to maintain price stability in the euro area as a whole. Therefore, ECB monetary policy can only deal with pan euro-area shocks, leaving to fiscal policy the task to counter idiosyncratic or asymmetric euro-area shocks. Unfortunately, the room for fiscal policy is currently very limited in the euro area and, as a result, ECB non-standard monetary policy has been instrumental to support individual Member States hit by asymmetric/national shocks. However, Cour-Thimann and Winkler (2013) show that the ECB has been more successful at repairing transmission mechanism of monetary policy rather than at delivering additional monetary stimulus.
1. ECB’S NON-STANDARD MEASURES

In May 2010, ECB President Trichet introduced, the Securities Market Programme (SMP). The aim of the programme was to buy government bonds of euro area Member States in the secondary market to address “severe tensions in some of the euro area bond markets” and by fully sterilizing the bond purchase. The programme did not specify any "size" or "time" limit for the purchase.¹

These purchases were stopped in May 2011 and restarted later until the 6 of September 2012, when the new Outright Monetary Transactions (OMT) programme was announced.

At the end of 2012, the outstanding amount of SMP holdings at the ECB was EUR 208 billion at book value. The SMP Programme has been less effective than expected because of the dominant market perception that the ECB had taken the decision reluctantly.

In December 2011 and in February 2012, President Draghi introduced two LTROs (three-year Long-Term Refinancing Operations) with the aim to alleviate credit market tensions (on long-term interest rates) in distressed euro area Member States following the break-up of the monetary transmission mechanism. That is, reductions of policy rates were not adequately transmitted along the yield curve in several distressed economies of the euro area.

According to the Bank Lending Survey (BLS), ECB non-standard monetary policy measures have had a positive impact as they have lifted the prospects for real GDP growth and loan provision for non-financial corporations (see also Darraq-Paris and De Santis, 2013). Nevertheless, commercial banks from distressed Member States stopped using the interbank market for funding, given that they could obtain cheap financing directly from the ECB.

In September 2012, President Draghi introduced the OMT Programme, designed to replace SMP and to address its deficiencies. So far, the OMT has been much more effective than the SMP is stabilising yields, most likey because the terms of its announcement were “unlimited bond purchases”: who wants to bet against an unlimited firewall? The OMT is not "targeted to overall monetary conditions" but only to “disruptions in certain markets” subjected to “malfunction” or to “irrationality” by investors, which could “hamper” the monetary policy transmission and can only be activated under “strict conditionality” (i.e. an ESM programme).

Lately, in July 4 2013, ECB President Draghi introduced for the first time in the ECB history the so-called “forward guidance” on interest rates by stating “Our monetary policy stance is geared towards maintaining... the key ECB interest rates to remain at present or lower levels for an extended period of time”.² The reason for this new form of monetary policy measure is to anchor long-term interest rates, i.e. the key rates for spending and investment decisions, to short-term interest rates, “given the broad-based weaknesses in the real economy and subdued monetary dynamics” and in presence of contained inflation expectations in the mid-term.

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¹ The SMP Programme was responsible for the resignation of Jürgen Stark, member of the ECB Executive Board, in September 2011.
2. TWO TYPES OF NON-STANDARD OR UNCONVENTIONAL MONETARY POLICIES

Two different types of non standard or unconventional policy measures have been activated by major central banks, including the ECB. The first is “purchasing financial assets in the markets”. The second is making a “commitment” to keep interest rates very low for a prolonged period of time or until a precise economic target is finally met (The Economist, 2013)

The first non-standard policy measure is used when the central bank aims to reduce the “present cost of borrowing”. It buys medium- and long-term financial assets in the market (mainly government bonds, but also corporate debt and household mortgages) to lower present and medium and long-term rates in order to reduce the present borrowing costs across the economy.

The second non-standard policy measure is used when the central bank aims to reduce the interest rates that people expect to pay and receive in the future, that is the “present and future cost of borrowing”. Forward guidance is basically a commitment to keep short-term interest rates low “until a certain economic target selected by the central banks is achieved” or “during an extended period of time”.

In the FED case (resp the BoE), “forward guidance” translates into a commitment to keep short-term interest rates low until the level of US unemployment does not fall below 6.5 % (resp. 7 % in the UK).

In the ECB case, there is not an explicit economic target, such as a level of growth or of unemployment, but only the condition that “the economy would need to improve better than in our base scenario”. In order to achieve this less concrete goal the ECB is committed to keep its Main Refinancing Rate (MRO) at a low level for an extended period of time. The ECB was well known for observing a strict policy of no commitment. It used this new “system of communication” for the first time since its creation.

3. SOME DRAWBACKS OF NON-STANDARD OR UNCONVENTIONAL POLICIES

Both non standard and unconventional measures have their own drawbacks.

In the case of “purchasing medium and long-term financial assets in the market”, the main drawback is that even if it market rates and “national” investors tend to be affected, “foreign” investor’s asset allocation decisions may also react, thereby reducing the effectiveness of central bank’s policy.

According to The Economist (2013) a combined USD 9.7 trillion assets have been purchased so far in the crisis by the FED, ECB, BoJ, BoC and BoE and are now central bank's balance-sheets. But foreign investors hold USD 5.6 trillion assets from these countries. China and Japan own more than the FED. In the case of the BoE USD 1.4 trillion are owned by foreigners. The FED bought assets worth USD 2.8 trillion in the five years after 2008 and foreign investors bought another USD 2.3 trillion helping the FED decision to lower rates. But, in 2013, by contrast, foreign investors sold USD 45 billion of US Treasuries leading to an increase in those interest rates that the FED wanted to reduce.

In the case of “forward guidance”, the drawback is that investors and markets, both national and foreign, may ask for stronger commitments over time to test the time-consistency of central bank policy.

As Finn Kydland and Edward Prescott (1977) have shown in their famous paper, the “time inconsistency” problem arises when a commitment cannot be maintained. In the case of a central bank, future commitments lack credibility if people think that the central will “backtrack” later in its promises. For instance, it cannot be credible a commitment to hold interest rates low for a prolonged period of time if, in its announcement, it is also added that, “if circumstances change, we will raise rates”: A commitment must be time-consistent to be operational (The Economist, 2013).

As a clear evidence of these drawbacks, interest rates in the US and the UK are rising today, despite FED and BoE commitments. Investors are asking for stronger commitments than those made by the FED and the BoE. By contrast, an example of “strong commitment” with, so far, highly efficient results has been President Draghi’s famous sentence, in July 2012, that he would do “whatever it takes” to save the euro.

The present “forward guidance” policy by the ECB does not seem to be as as strong as in July 2012, when expectations in the financial markets of a “Euro break up” were very high. It also appears to be less strong than that of FED or the BoE as it lacks of a clear macroeconomic target (e.g. the level of unemployment).

However, during his introductory statement to the press conference and in the Q&A President Draghi gave more hints to the markets and emphasised ECB’s commitment by stating that: “our monetary policy will be accommodative for as long as necessary”; “the Governing Council has reached a unanimous decision on the forward guidance”; “an extended period of time it is not only twelve months”. He also said that “50 basis points is not the lower bound” for the policy rate and “a cut in ECB key rates includes also the deposit facility” and “does not exclude a negative deposit rate” and “credit flows continue to be weaker and weaker”.

A member of the ECB Executive Board, Peter Praet (2013) has recently recognised that the formulation “for an extended period of time” marks a change in the ECB communication strategy on monetary policy and must be interpreted as a form of “forward guidance”. He also stated that “the way in which central banks communicate decisions is perhaps as important as the decision itself”.

Non-standard and unconventional Monetary Policy Measures
Accordin to Praet, forward guidance, by keeping the short-term rate at the present level for an extended period of time, exerts a downward pressure on long-term interest rates and engineers an easing on credit conditions, “even though the level of the short-term interest rate remains constant”. Praet claimed that the ECB “forward guidance” includes an “easing bias”, conveying the notion that “we have not reached the lower bound” on our key interest rates and “we have not run out of ammunition”.

Another ECB Executive Board member, Benoit Coeuré (2013) has mentioned three principles which guide ECB non-standard policy measures:

The first principle is that any provision of excess liquidity should be specifically targeted towards the market which is most impaired by market constraints making sure that the provision of liquidity produces the most beneficial effect per unit of intervention.

The second principle is based on the observation that financial market fragmentation tends to lead to “an unwarranted risk premia and create a self-fulfilling process that can be devastating”. Therefore, non standard measures have incorporated an element of “insurance against those risks”: such as the extension of their maturity up to 3 years, in the case of the LTROs, or the coverage of “tail risks” due to expected currency denomination, in the case of the OMT.

The third principle is a direct consequence of the second, given that it is well known that any “provision of insurance against adverse scenarios can generate perverse incentives”; the ECB has chosen to offer “partial insurance” as a guiding principle to mitigate “moral hazard” concerns. The conditionality imposed to the OMT Programme is a clear example of the application of this principle.

The IMF (2013) believes that unconventional monetary policies are warranted when economic conditions do not improve or even worsen. Yet, their growing scale raises risks that need to be mitigated with macroprudential policies. If monetary policy is called to do too much and the breathing space it offers is not used to engage in needed fiscal, structural and financial sector reforms then it is not the solution.

These reforms are essential to ensure macroeconomic stability, entrenching the recovery, and eventually allowing for the unwinding of unconventional monetary policies. Therefore, structural reforms need to be part of the conditionality for the use of non standard monetary policies.

Jordi Galí (2013) shows that in the case of rational asset bubbles, a “leaning against the wind” interest rate policy may raise its volatility. The optimal monetary policy must strike a balance between stabilisation of current aggregate demand, which calls for a positive interest rate response to the bubble, and stabilisation of the bubble itself and hence of future aggregate demand, which would warrant a negative interest rate response to the bubble. If the average size of the bubble is sufficiently large the latter motive will be dominant, making it optimal for the central bank to lower interest rates in the face of a growing bubble.

Giannone, Lenza, Pill and Reichling (2011), show how the Eurosystem has been able to avoid a calamity similar to the Great Depression, through adequate non-standard monetary policies.
4. ASSESING THE EFFECTIVENESS OF THE ECB NON-STANDARD POLICIES

The main issue that the ECB is facing regarding these non-standard policies is that the euro area is not (yet) a single federation or confederation of countries with a centralised fiscal policy as it is the case of the other countries that have applied similar policies (the US, Japan, the UK and Canada).

The euro area is only a single market and a monetary union of 17 Member States, each with its own government and its own treasury. Investors have also realised (at least since 2010) that the euro area not yet a Banking Union and that monetary policy cannot easily deal with country-specific asymmetric shocks forever.

Therefore, the ECB is currently doing a huge effort within its own narrow mandate along three key dimensions: trying to avoid a deadly break-up of the euro area; adapting and targeting the single monetary policy to address problems in individual Member States, an extremely complex task; ensuring effectiveness of monetary policy with policy rates close to the lower bound. These drawbacks notwithstanding, the ECB is learning fast and non-standard measures are helping to improve the effectiveness of monetary policy across the euro area. The ECB intervention has been instrumental to save the euro and the monetary union.

The ECB faces the additional difficulty that its policy decisions are often criticised or even challenged by some euro area central banks, by politicians and, sometimes, even by national constitutional courts. These are not the best ways to address a fully independent euro area central bank.

As a way of avoiding this kind of critiques, the ECB should publish the minutes of Governing Council decisions or discussions as the FED and the BoE do. The issue here is that both the FED and the BoE have a smaller group of members who propose the monetary stance: the Federal Open market Committee (FOMC) and the Monetary Policy Committee (MPC). Their task is to target inflation, growth and unemployment. The ECB does not have a formal or official similar body, neither a dual or triple mandate.

Many of the critiques to the ECB monetary policy and to its non-standard policies are therefore mostly unwarranted.

The lack of a true dual mandate for the ECB makes any “commitments” in “targeting real economic magnitudes” very difficult.

The recent Geneva Conference on the World Economy has dealt with the issue of “Exit strategies by central banks”. There has been a widespread agreement on three key issues (Charles Wyplosz, 2013): a) Financial stability is now recognised as an implicit responsibility of central banks; b) Purchases of long-term assets by central banks should not be abandoned; c) Central banks are now involved in macro-prudential financial supervision, which is not separate from micro-prudential supervision. Carpenter, Demiralp and Eisenschmidt (2013) have estimated the effects of the ECB’s non-standard measures on the euro area bank funding markets under stress. They found that these measures have reduced bank funding volatility, increase loan supply and sustain economic activity.

In sum, the ECB is very independent but its hands are, somehow, handcuffed by its narrow mandate. This is why there are no unintended consequences following any of its non-standard monetary policies. In sum, let us the ECB do its job as better as it can, within its narrow mandate, and only then, criticise it if it was not able to achieve the expected results.
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